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# FRBSF WEEKLY LETTER

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## Banks and High Leverage Debt

When the average degree of leverage in the economy rises, it is not surprising to observe an increase, on the margin, of lower quality debt. One manifestation of this in the primary securities markets is the issuance of "junk" bonds, or securities of below-investment-grade quality. In the banking environment, the market pressures for increased leverage have fueled growth in loans that finance highly leveraged transactions (HLTs) in the economy.

A high degree of leverage in the corporate sector is a source of concern because, some argue, it may make the economy less resilient in the event of an economic downturn. Moreover, the presence of HLT loans in bank portfolios is of special concern because these loans expose banks to increased risk, thereby potentially imperilling the banking system. Some economists feel that the credit-intermediation and payment-system functions that banks perform are not easily replicated by other institutions in our economy and thus deserve special insulation from such risks.

This *Letter* discusses the origins and nature of HLT debt in bank portfolios. HLT lending is a significant component of bank portfolios. Regulators must be wary to avoid concentrations of this lending, particularly in capital-deficient banks.

### **Banks and HLT debt**

Bank HLT lending is strongly associated with the present merger and corporate control phenomenon. According to data from a recent Federal Reserve survey, 60 percent of the lending to highly-leveraged businesses was associated with leveraged buyouts (LBOs), 24 percent with equity buybacks, and four percent was extended to ESOPs (employee stock ownership plans). The Federal Reserve defines high leverage financing as credit extended for restructurings or acquisitions resulting in a debt-to-asset ratio of 75 percent or more on the part of the borrower.

Mergers, acquisitions, and internal refinancings involve decisions about the financial structure

of firms, including choices regarding the ratio of debt-to-equity and the types of debt instruments that will be used. As previous issues of this *Letter* (April 10, 1987, and November 24, 1989) have demonstrated, it is likely that recent changes in the tax system have stimulated increased use of debt by U.S. corporations. This increase in corporate leverage, in turn, has resulted in deterioration in the rated quality of outstanding corporate debt and an increase in the issuance of new, below-investment-grade debt.

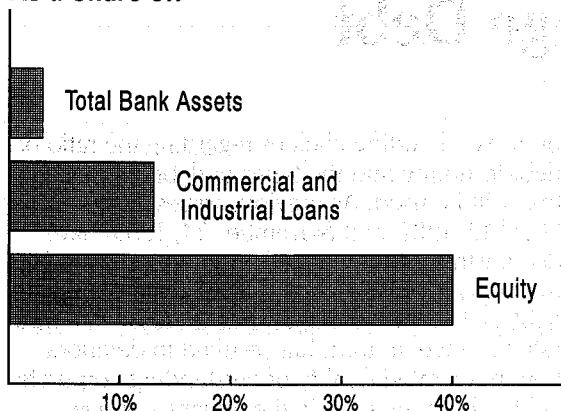
Thus, the increase in HLT financing at banks and elsewhere reflects these incentives to increase the leverage of business enterprises. However, the extent and type of involvement of banks in such lending is limited by several general regulations. National banks, for example, may not invest in equities and may invest only in investment grade bonds, limiting banks' direct holdings of junk bonds and other "mezzanine"-type securities. Also, unsecured lending to a single borrower is limited to an amount less than 15 percent of a bank's capital. Similar restrictions apply to banks with other types of charters, as well.

A bank can minimize the impact of some of these constraints by establishing venture capital or commercial finance companies as subsidiaries separate from the bank. Nonetheless, regulatory restrictions have had a strong impact on the extent and nature of banking organizations' involvement in the HLT debt markets. The loans made by banks tend to be term loans, and tend to be senior debt secured by the assets of the borrowing corporation. The HLT term loans have interest rates that are 1½ to two percentage points over prime. Most HLT loans are originated by one of the large commercial banks, which then sells 75 to 90 percent of the obligation to other banks (typically, foreign and regional banks).

Banks have not been as heavily involved in the other main HLT debt market, the so-called bridge

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## HLT Lending by Banks As a Share of:



Based on 1988 and 1989 data.

loan market. Bridge lending involves short-term (three to four month) loans that provide corporations with temporary funding while the permanent sources are assembled. The large loan sizes and relatively accelerated evaluation processes involved in such lending are not well suited to the regulatory environment in which banks operate. Moreover, the way these bridge loans are syndicated tends to afford banks less discretion over the terms of their participation than they or their regulators consider desirable. Banks have participated in the bridge loan market, however, via pooled funding mechanisms set up by investment banks or other commercial banks.

### The risks

The aggregate scale of HLT-related lending is not easy to calculate because the various surveys of bank portfolios employ different definitions of HLT debt. Private sector studies conducted as of early 1989 suggest that between \$70 and \$80 billion of bank assets could be considered HLT-related lending. This represents 12 to 13 percent of total commercial and industrial (C&I) loans by banks, and two to three percent of total commercial bank assets. More recently, as part of the Shared National Credit Program, various bank regulators inventoried HLT debt. Using a somewhat broader definition of HLT financing, their estimate for 1989 was nearly twice this size, at \$175 billion. To date, lending appears to be growing at about a 15 to 20 percent annual rate.

Even if the more modest, private sector estimates are used, HLT debt is large relative to the capital

cushion of the banks involved and is, by its nature, a riskier asset than a conventional credit. At present, the stock of outstanding HLT-related debt is equivalent to at least 40 percent of the equity of all commercial banks, or about half the concentration observed for LDC debt at its peak. For the ten largest HLT lenders together, this ratio stands at about 60 percent, and ranges as high as 140 percent for the most actively involved institutions.

There appears to be fairly broad industrial diversification of HLT debt exposures at banks. Of the financings assembled in 1988, 50 percent were in manufacturing, 40 percent in the services industry, and 10 percent in natural resource sectors. In addition, the syndication process limits any one bank's exposure significantly. Few banks have more than \$50 million invested in an individual financing, even though regulations would permit as much as \$90 million (unsecured) and \$150 million on a secured basis for a \$10 billion bank. The largest HLT lenders have portfolios comprising 75 or more individual HLT financings.

Nevertheless, risk in HLT-related financing remains an important concern of bank regulators. Federal Reserve surveys show that the majority of bank HLT loans (56 percent) rely on corporate cash flow (versus open-market refinancing or asset sales) for repayment of the loans. Should cash flows deteriorate because of adverse economic conditions, a substantial number of loans would not perform as expected.

Although the performance of HLT debt held by banks to date has generally created no major problems for banks, the banks themselves (according to survey responses) expect about a 70 percent higher charge-off rate for HLT debt than for other C&I lending. Moreover, charge-offs rose significantly in 1988, after a decline in 1987.

### Should banks extend HLT debt?

For some, risk considerations call into question the appropriateness of bank involvement in HLT debt markets. They argue that bank and thrift involvement in high risk investments may be merely a means of exploiting the deposit insurance guarantee and as such, jeopardizes the stability of the banking system. At the same time, however, there are legitimate reasons for bank involvement in the HLT debt market.

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First, bank participation in the HLT debt market is consistent with the credit-intermediation role of banks in our economy. In particular, a number of economists argue that banks exist because of their superior ability to monitor risky loans. While direct placement markets (commercial paper and bond markets) can serve firms with well-known reputations and obvious cash-flow characteristics, lenders with more intimate information about the borrower are needed to serve the financing needs of more idiosyncratic markets. On these grounds, it may be logical for banks to serve components of the HLT market that cannot be more efficiently served by direct placement markets and venture capital firms.

Second, although HLT debt is risky, it can safely be held in the portfolios of banks that have sufficient capital to protect liability holders and the deposit insurance fund from the attendant risks. Indeed, having sufficient capital at risk gives banks an incentive to scrutinize and monitor HLT credits carefully.

This reasoning suggests, however, that it may be prudent to restrict HLT-related lending (and other

risky activities) at institutions with thin capital cushions. Under the present deposit insurance system, a thinly-capitalized bank can obtain its deposits at rates that do not vary significantly with the bank's level of portfolio risk. At these institutions, management will have an incentive to operate with minimum capital, and to over-invest in risky projects without adequate controls.

### **Strong capital is the key**

HLT lending by banks very likely is a manifestation of the broader trend toward increased leverage in our economy. Allowing banks to respond to this trend by providing HLT credit services enhances competition in these markets and promotes economic efficiency. Therefore, it is important that sound banks be allowed to participate in the provision of HLT credit services. To properly discipline the participation of insured banks in such markets, however, this activity (and other risky activities) should be restricted to those banks with generous capital positions.

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